DOW THEORY LETTERS INC.

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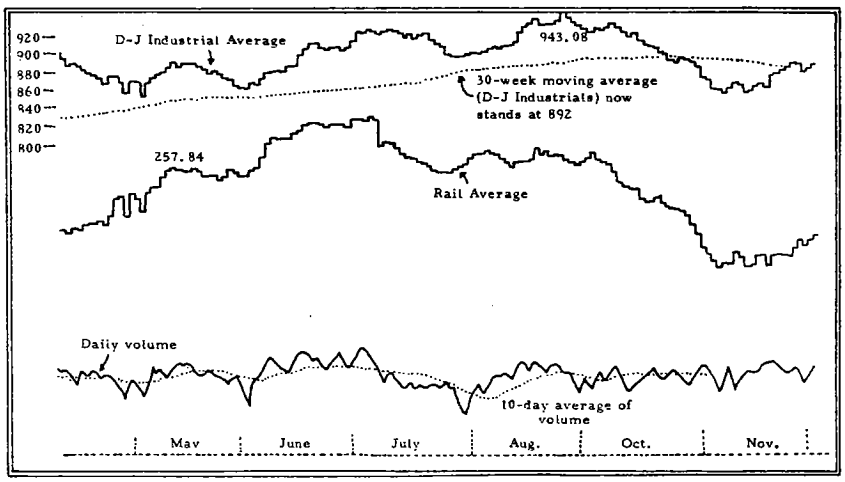
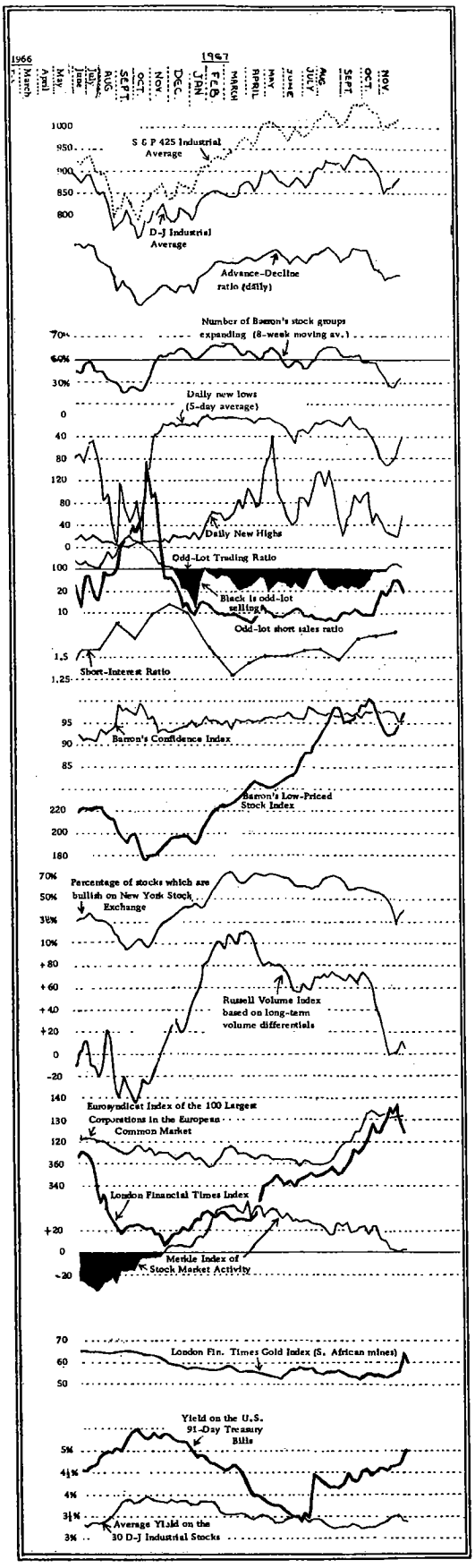
THE MARKET: Most people do not seem to realize that devaluation is a type of default—or to put it more brutally, bankruptcy. Bankers and investors consider devaluation a form of bankruptcy because the devaluating nation is simply watering down its currency (in terms of gold), and attempting to pay off its debts with cheaper money. For instance, all American holders of British stocks now receive dividends which are 14.3% below those received before devaluation. Holders of all British obligations with interest paid in pounds are subject to the same harsh treatment.

The only outstanding factor about the British devaluation is that the pound is a reserve currency, a currency which represents 9% of the Free World's wealth. The pound was supposed to be as good as gold, for that, essentially, is the definition of a reserve currency. And, of course, that was and is DeGaulle's main bone of contention—that neither the pound nor the dollar is anything like "as good as gold". DeGaulle believes that (given the profligate management of the U.S. and Britain) only gold or gold-backed currency is as good as gold. The pound's collapse was a tremendous victory for DeGaulle, and all thinking men know it.

The trend throughout the world is and has been towards debasement of paper currency. In the last five years Canada, Syria, Indonesia, Afghanistan, Nationalist China, Venezuela, Korea, Yugoslavia, South Vietnam, Brazil, Finland, Britain, Denmark, Spain, New Zealand, Cyprus, Malta, Bermuda, Israel and Ireland have all devalued. During that period U.S. gold losses have mounted and with only $2.9 billions of "free gold" to cover foreign claims ($13 billions if we remove all currency backing), the U.S. has potential claims of $30 billions against its gold hoard. Is it any wonder that informed money is betting against the U.S. being able to resist devaluation or a world re-valuation of gold—perhaps to $70 or $100 per ounce? It appears to be only a matter of time.

Meanwhile, the U.S. stock exchanges are in the grip of great emotional upheavals. Informed investors remember that in 1931 British devaluation led the world into the Great Depression. They know that if the U.S. is to defend the dollar, higher taxes will be needed, higher interest rates will definitely be needed, controls may be needed. Britain put the writing on the wall. She could not hold the pound against a trend of British pop-thinking, inefficiency and over-spending. She would not do the painful things which were necessary to protect the pound.




1966
1967
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily new lows (5-day average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fin. Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

 The U.S., with a fantastically expensive war in progress, with grandiose Great Society schemes in operation, will not do what is necessary either. For in order to do what is necessary, the Administration would have to institute a series of operations which, among other things, would knock the stock market to its knees. And that is hardly the type of thinking which appeals to our Neo-Keynesians.

On Wall Street the Averages have been engaged in their first important rise since late-September. As so often happens, the turn came in the face of the bad news (i.e., devaluation). We now know that the 94 drop in the Dow Industrials from the September high of 943.08 to the November low of 849.57 represented the market's way of discounting important trouble ahead. By the time the actual bad news broke, the market had discounted that news. Thus, the decline first, then the rally in the face of the actual fact of devaluation.

Analysts all over the nation are now participating in their favorite pastime, guessing "how far the move will carry". This, to my mind, is a fruitless occupation. I would prefer simply to refer to history. All movements are ultimately corrected. These corrections tend to retrace one-third to two-thirds of the ground previously lost (or gained). Thus, a normal retracement for Industrials of the September-November 94 point drop would take the senior Average back to the 880-910 area. As of this writing, the Dow has pushed well into this area. Rails have acted considerably weaker than industrials and have corrected only a small percentage of their 47 point drop since the August 4 high of 274.49.

It is still rather too early to gauge the underlying technical strength of the rally. The rally has been mostly confined to Industrials with Rails and Utilities sluggish. The 40-Bond index has been hitting daily new lows (a very negative indication), with a fresh low since 1933 having been struck as late as November 28. The advance-decline ratio has shown a slow rate of ascent, showing that breadth has not been impressive on the rise. The Russell Volume Index jumped to plus 13, but it will take a few more weeks to see whether this important Index is signalling anything more than a technical rebound. I would think that a definite upward zig-zag in the Russell Index would be one of the potentially really hopeful signs for the bulls. This, of course, has not yet occurred. The Merkle Index is at plus five; it has not yet turned negative, and this is currently a hopeful sign for the bulls.

GOLD: Adherence to the gold standard tends to force statesmen and politicians to be honest. This, in a nutshell, is the reason why so many statesmen and politicians dream of getting rid of gold. Politicians need votes, and to get votes they feel they have to buy them — by whatever means necessary. Obviously, a dollar or a pound or any other currency tied to gold (on a reserve backing basis) cannot be inflated or demonetized beyond a certain point. Of course, the gold base of a currency can be reduced (which the U.S. has done) but sooner or later, if the politicians' spending plans are limitless, a fiat currency is what is really desired.

The U.S. Administration would love a fiat (no gold backing) currency. They would love no limits on printable dollars. They would be willing to trade steady inflation (which is legalized robbery since it wipes out the value of all savings, pensions, fixed incomes, etc.) for unlimited Government "buying power". The Common Market nations do not want inflation. They have, in the past, experienced the agony of massive inflation and collapsing currencies. As a result, they tend to trust only gold; moreover, they desire the discipline which gold backing imposes on any honest currency.

The Common Market nations have learned how to produce and how to save. The total gold holdings of the Common Market now surpass that of the U.S., which is another way of saying that the Common Market has a "long position" in gold. This fact alone makes it certain that the Market nations will not go along with any U.S.-sponsored fiat money proposals regarding the dollar.

The spiritual leader of the Common Market is France's DeGaulle. DeGaulle has long contended that national currencies (dollars, pounds) are not as realiable as gold for purposes of international reserves. Furthermore, DeGaulle claims that the chronic deficits in the dollar and the subsequent printing of new dollars are being used to buy up European properties and capital. DeGaulle's thesis, believed by most conservative economists, is that sooner or later a currency subject to chronic deficits will topple. The proof, DeGaulle has stated, will be forthcoming.

Thus, the collapse of the pound came as a singular victory for DeGaulle. Next, he has turned to the dollar, and here the situation is ironic. For little France, with a fraction of the reserves of the U.S., is now being accused of attempting to crush the currency of the strongest nation in the world. DeGaulle has only one thing on his side, and that is the fundamentals. All history indicates that inflated currencies will collapse, and that they will collapse even more quickly when pressure is applied. The pound devaluation (in the face of three tedious years of denials thereof) was the first shocker. DeGaulle is out to prove that neither the pound nor the dollar deserve their status as reserve currencies with the IMF. He is out to prove that just as annual deficits, overspending, demonetization and inflation toppled the pound, it will also topple the dollar. The U.S. has fought that fundamental thesis for years — with gimmicks. The gimmicks are about to run out.

The London Gold Pool is a group which was set up for the purpose of stabilizing the price of gold by buying or selling bullion whenever necessary. The group is headed by the U.S. which supplies 59% of the needed gold. Last June France pulled out of the gold pool. In doing so she was saying that she would no longer participate in a manipulation operation which was doomed to failure. It is now rumored that Italy and Belgium want to withdraw from the Pool. In a matter of months the U.S. could be the sole owner of the gold pool, thereby having to supply all the gold wanted by gold buyers throughout the world. This would be a particularly unpleasant position in the event of a chronic run on gold.

As might have been expected, the British devaluation was a compromise between the "no devaluation"promised by Wilson and the 30% devaluation which many authorities believe actually was needed. The result, a 14.3% devaluation. In this writer's opinion, the 14.3% will do little towards curing Britain's trade problems. Already we read that the devaluation has done nothing for the pricing of autos and steel brought into this country from Britain. In both cases, prices were adjusted upwards thereby offsetting virtually all the benefits of the devaluation. If the devaluation was all that was needed, it is obvious that the British bank rate would not have been raised to 8%, highest in 53 years. That 8% is supposed to draw money like a magnet— to Britain. But what Britain has done is to produce an economic stimulent, a devaluation, and also couple it with the highest interest rates in the world, which will act as a depressant.

The brutal fact is that in order to correct their trade balance, Britain is going to have to face life in the world markets. She is going to have to be viciously competitive, she is going to have to learn how to produce efficiently and at a price. Nothing which is occurring in Britain today is tending in that direction. Without the will or the know-how, devaluation will prove just a trick, and already critics are talking about a second devaluation being needed just to start Britain on the road to correct pricing of its merchandise.

* * * *

Contrary to popular opinion, the consequences of the British devaluation are going to be deflationary— not inflationary. The new 8% bank rate in England is drawing money from all over the Continent, and it has been estimated that upwards of $4 billions in Eurodollars ("hot money") could move out of Europe and into England. There are $2.5 billions of European dollars held in U.S. banks which could now go to England. This money should be moving now, but it will take a few months before we receive the actual statistics.

* * * *

According to Eliot Janeway, "……the victory which DeGaulle had won over Wilson and Johnson is guaranteed to commit any lingering hopes for a European recovery into a scarcely dignified funeral." Later Janeway states: "If the package of lower exchange rates and higher tax and interest rates Wilson has been made to swallow does not prove digestible (and we don't think it will be), the next step will be another 15% devaluation for England and a full 30% counter-devaluation for Europe."

* * * *

The Britain devaluation is guaranteed to hurt the U.S. trade position. But even before devaluation, this late announcement was issued: U.S. exports fell in October while imports rose. This had the effect of narrowing the U.S. trade surplus to $166 million in October, down from $416 million in September and $319 million in October, 1966, and the worst showing in 2½ years. Is it any wonder that people are speculating against the dollar?

* * * *

My office is about 17 miles from the Mexican border, and I naturally receive many comments regarding holding gold in Mexico. In a sentence, it is illegal for U.S. citizens to hold title in gold bullion, in the U.S. or outside it. While it is true that bullion may be purchased in Mexico and held in secrecy in Mexican bank vaults, I can hardly advocate this illegal procedure.

As a commentary about Mexico, it is worth noting that the Mexican peso is backed by 50% gold and is listed by the IMF as one of the hard currencies. However, the international interest in gold has also hit Mexico, and the purchase of gold coins recently reached what is described as panic proportions. The Mexican mint is now working on a 24-hour a day basis, attempting to produce enough of the much-wanted gold "centenarios", which are the standard gold pieces of Mexico (they are worth $48).

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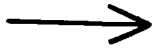
MOST PATHETIC STATEMENT OF THE MONTH, Dept.….
(From Newsweek, Dec. 4):



But while Martin believes in paying for things, he is no slave to fiscal orthodoxy. Thus he hastened to point out last week that he was not proposing a balanced budget. "That would collapse this economy," he said simply. Then he added: "But I do think we have to reverse the trend."

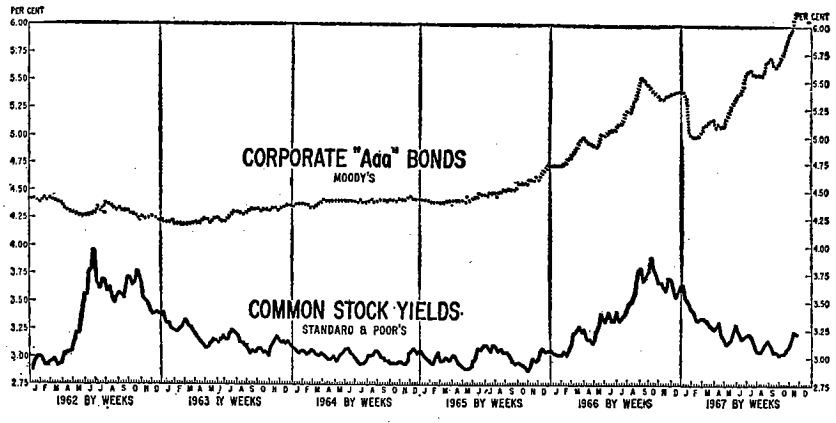
BOND SPECULATION: Unknown to most people, the biggest speculative game on Wall Street today is in Government bonds. The bonds can be purchased with financing as low as 5% with rumors of certain large interests receiving financing as low as 3%. At 5% a man could purchase 100 4¼'s of 1987-92 (value at maturity, $100,000) at the current market price of $81,000. He would put down roughly $4000 in cash and finance the rest. If interest rates go down and the bonds rally to say 89, he would double his $4,000 investment. On the other hand, if the bonds dropped to 77 he would be wiped out.

Therefore, the big "if" in this very aggressive speculation is the trend of interest rates. In a phrase, I do not advocate speculating in bonds at this time. A case can be made either way as to whether interest rates have seen their highs or whether they are heading still higher. Technically, most Governments have declined fantastically from their 1967 highs, and this is a plus for the trader in that they could rally simply because they appear "oversold".

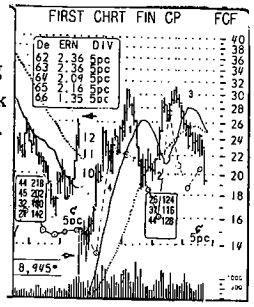
Nevertheless, the case for lower interest rates is still far from conclusive, and I firmly believe that most people are underestimating the problems that still lie ahead for the pound and the dollar. Defending the dollar could well require higher interest rates than those which now "seem high," I note this from friend and economist Eliot Janeway in his latest report (and Janeway has been awfully good at calling the troubles for the pound): "For the pound, considered on its own, and making allowance for the parallel fall in American prestige on the financial front, remains overvalued and vulnerable at $2.40. Moreover, taking the confidence factor and the arithmetic pressures together, the dollar is likely to have more trouble and will be subjected to more severe pressures defending sterling at $2.40 than were encountered at $2.80."

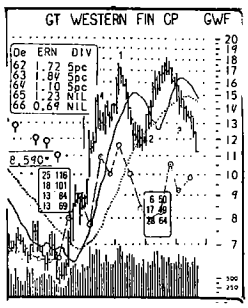
If Janeway is correct, bond speculators could have far from easy pickings in the months ahead.

AGAIN: Last week the yield spread between stocks and bonds opened to another all-time record, this despite the recent decline in the stock market. Standard & Poor's 500 stock index afforded a yield (see chart) of 3.22%, while Moody's Aaa-rated corporate bond Average provided a yield of 6.12%. This put the adverse or negative yield spread at 2.90%, in favor of bonds. This means that at current rates, the yield on common stocks would have almost to double before they provided the same yields as the highest-rated corporate bonds. Thus, one of the most fundamental investment yardsticks remains steadfastly unfavorable for common stocks; it is as unfavorable as it has ever been any time in history.



WHERE TO LOOK: There are a number of highly intelligent theories regarding what to expect and where to look during the period ahead. One school (my friend J. Irving Weiss is a leading member of this segment) believes that the Free World will now seek to protect its currencies from further inflation. This means halting the money expansion and defending currencies with higher interest rates. Another school believes that the world will seek to offset trouble by doubling or tripling the price of gold (thereby doubling or tripling actual gold reserves in terms of price). A third school believes that the U.S. will somehow lead the Free World out of its monetary mess via trial-and-error and hodge-podge legislation.





I do not believe the last school of thought is going to be right. I would not take bets on which of the first two schools will ultimately be proved correct. However, by holding 10% to 15% in gold shares and the rest in 91-day Treasury bills, we hold a hedge which would protect us to a large extent regardless of which of the first two schools eventually proves right.

Judging by the markets, the contest is still much in doubt. Look at the bottom of the page 1 composite chart. There we see the accelerating rise in 91-day Treasury bills. On December 1 the bills hit a 1967 high yield of 5.01%, the first time 5% has been touched since 1966. Now study the two weekly charts of two representative and leading savings & loan holding companies (charts courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas). Note the "double tops" and the subsequent testing of the preceding secondary lows. These stocks are gauging the possibilities of another round of "disintermediation," which is Wall Street's name for moving the money out of the financial institutions and into higher yielding bonds. If intermediation trouble is to come about, these stocks should smash back to the 1966 lows.

The third place to look is at the gold shares, and all of these are now in established uptrends. If revaluation is to be the answer, these uptrends should hold steadfastly intact. With England's bank rate at 8%, with Japan and West Germany now feeling the effects of high interest rates and devaluation, the entire battle should heat up. Dislocations and problems are bound to intensify during 1968. It will be a battle of interest rates or an attempt to ease interest rates via revaluation. The third alternative is an easing of interest rates via an international economic slump. In the event of the last, Treasury bills (even though they drop in yield) will provide the ideal protection.